

# Federal Taxation in Total War

Randolph E. Paul

Follow this and additional works at: <http://scholarship.law.cornell.edu/clr>

 Part of the [Law Commons](#)

---

## Recommended Citation

Randolph E. Paul, *Federal Taxation in Total War*, 28 Cornell L. Rev. 141 (1943)  
Available at: <http://scholarship.law.cornell.edu/clr/vol28/iss2/4>

This Article is brought to you for free and open access by the Journals at Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell Law Review by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact [jmp8@cornell.edu](mailto:jmp8@cornell.edu).

## FEDERAL TAXATION IN TOTAL WAR†

RANDOLPH E. PAUL

For nearly a year I have been engaged on what I have discovered to be the most unpopular job in the world. I have been privately and publicly advocating the imposition of higher taxes upon the American people—higher than they have ever been asked to pay in their entire history. This experience has taught me the truth of a New Testament adage: "Where your treasure is, there will your heart be also."<sup>1</sup> The heart, more than the head, I have sometimes thought. At any rate, you were kind to invite into your midst "Public Enemy Number 1," who will never forget the remark of Edmund Burke: "To tax and to please, no more than to love and be wise, is not given to any man."

I am going to assume a high degree of interest on your part in the most challenging fiscal problem the world has ever known. I am going to assume that you want to hear the facts underlying this problem, however grim and unpleasant they may be. Some there are who want to evade the issue, but you are not of that pale cast of thought. At least, so I have decided. I will, therefore, tell you the blunt truth as I see it—candidly, without equivocation, without any attempt to pull my punches. I will call a spade a spade, in spite of Oscar Wilde's epigram that those who call a spade a spade should be given a spade. I think you can take what I wish to say, and I would not like to think that you wanted anything less direct.

### *The Growth of Expenditures and National Income*

If some of you are bored with life, I suggest that you go back to the economic literature of the thirties. You will find that the financial world was in a state bordering upon nervous collapse about annual expenditures of from 4 billion dollars to 9 billion dollars by the Federal Government. People talked with grim apprehension about the mounting debt occasioned by such constructive expenditures as those for public works. Some of them violently protested against expenditures to provide food and housing for

---

†A lecture delivered at the Cornell Law School under the Frank Irvine Lectureship of the Phi Delta Phi Foundation, December 11, 1942. [Ed.]

<sup>1</sup>MATTHEW (King James' Version) 6: 21; LUKE (King James' Version) 12: 34.

the needy. All these dreaded expenditures lifted the public debt from 17 billion dollars in 1929 to 40 billion dollars in 1939.

I hope I may not be understood as being cavalier about our debt problem if I say that all the worry and fear of those days was in a relative sense little more than a tempest in a teapot. Following Pearl Harbor, the President on January 5, 1942, sent to Congress a budget message for the fiscal year 1943, proposing 56 billion dollars of war expenditures and recommending additional tax revenues of 7 billion dollars. Original goals became obsolete before they could be reached. On April 24, 1942, a budget revision added 14 billion dollars to these war expenditures. Again on October 3, 1942, the second revision added another 8 billion dollars, making a total estimated war expenditure for the fiscal period of 78 billion dollars. These figures, and expenditures that will have to be made in fiscal years to come, may well provoke grave concern. Taking into account non-war governmental outlays, total expenditures for the fiscal year 1943 will be 85 billion dollars, or more than \$600 for every man, woman, and child in the land. To be compared with this figure is the modest sum of 33 billion dollars spent during the three years, 1917 to 1919, of World War I.

#### *The Inflationary Gap*

Those of you who enjoy contrasts may not object to some further figures. Not long ago we were coaxing dollars out of their stagnant hiding places and into the market. We were trying to stimulate trade and industry. Our economic objective was critically described by some as being to spend ourselves into prosperity.

We managed in those far-away days of the recent past to increase our national income from a low in 1932 of about 40 billion dollars to the much higher figure of 71 billion dollars in 1939. But, to borrow from Mr. Churchill, this was "not even the beginning of the end." But it is perhaps the "end of the beginning." Next year our national income will amount to about 125 billion dollars. Notwithstanding greatly increased war taxes, those who receive that income will have left about 110 billion dollars, some 42 billion dollars in excess of what they had after taxes in 1939. We have spent ourselves into financial prosperity.

Does this mean that we have solved our economic problem? Not at all. We have merely changed our problem. Our people will have in 1943 a total purchasing power of 110 billion dollars, an increase of 36 billion over the year 1940 when they had only 74 billion dollars to spend. But at the best only 70 billion dollars worth of goods and services at present prices will be available to consumers in 1943. The difference between 110 billion dollars

and 70 billion dollars, 40 billion dollars, is the new problem. It is an excess we must absorb by more saving and by more taxes. If people save 25 billion dollars of that 40 billion dollars, there will still be left 15 billion dollars of spending power in excess of goods and services available. If this 15 billion dollars is poured into the market by consumers, nothing can save Mr. Henderson's price ceilings. Nothing can save our whole economic structure, as we know it today.

### *The Transition to a War Economy*

From a pre-war goal of increasing spending, we have come to a war goal of reducing spending. The story of this change in objectives is a story that cannot be too simply told. When conversion to war began, we had at our command a substantial reserve of unemployed natural and human resources. Although many of the depression unemployed had found work by 1940, there still remained in 1940 a welcome supply of untapped manpower. We had what seemed to be an abundance of raw materials. Formerly partly or wholly idle factories were available for the expansion of production. By using these idle materials and facilities, by adding new capacity, by using men who had been idle, and by training new workers, we were able for about a year and a half to increase our output of armaments and at the same time to continue to increase our supply of civilian goods. As consumers, we had simultaneously more money and more goods. Both our *money* income and our *real* income were higher than they had ever been before.

In this early stage the real cost of producing the implements of war—the extra work, the additional pressure, and the sacrifice of things we might have had—often seemed remote and unreal. The previously unemployed person regarded his new job, even though it required hard work, as a blessing rather than a burden. His higher income enabled him to buy more goods and services. Because civilian output was expanded, no one else had to receive *less* goods and services when the newly employed person received *more* income. There was relative plenty for everybody.

As our war output expanded, it was no longer possible to depend entirely upon the employment of equipment and labor that had formerly been idle. We were obliged to turn to other sources. We had to develop new supplies of labor, on the one hand drawing upon the women of our country and, on the other hand, training much of the existing labor force in higher skills. We had to curtail drastically private construction and the production of capital goods. Instead of maintaining, replacing, and adding to our existing equipment in the normal way, we were producing the implements of war. The rapidly expanding armaments program also made inroads on another

supplemental source of war production—our stocks of basic raw materials. Once our accumulated stockpiles of rubber, strategic metals, and scrap materials are depleted, they can be replaced only with great difficulty, if at all.

Until recently these three sources—unemployed facilities, deferred maintenance and construction, and stockpiles—have been sufficient to provide the major part of our war output. We have drawn heavily on only one segment of consumer goods output—automobiles, refrigerators, stoves, and other durable goods. Until recently we have maintained the supplies of consumer non-durable goods and services at levels above any that have ever been reached in this country.

These happy days are almost history. The demands of total war play no favorites with sources of increased output. To meet increasing demands, equipment and labor must be shifted from the production of the comforts, and even some of the things we have come to regard as the necessities of life, to the production of the implements of war. To produce more tanks, planes, and guns, and to feed our armies and our allies, we shall have to accept not only fewer automobiles, but also less heat, less clothing, and even less food. Furthermore, while we continue the principal business of winning the war, our houses, streets, transportation facilities, and, in considerable measure, our factories and equipment devoted to the production of consumer goods, will have to serve in substantially their present condition.

Had we planned this war, our timing of war production could have been better. If, for example, the United States had embarked on rearmament at the depth of the industrial depression, when a large part of our human and material resources were idle, the nation could have produced war materials without displacing existing civilian production. At that time our standard of living was substantially lower than in 1940, which marked the beginning of our defense program. It was under such circumstances that Germany began to rearm. She was thus enabled to utilize for war purposes substantially all of the increased output resulting from increased employment of men and machines. We cannot devote a comparable proportion of our resources to war without returning to depression levels of consumption, and without retaining at the same time prosperity levels of income and production. On a physical level we can, however, more easily curtail current civilian production because of the consumer capital we have accumulated during the years of relatively high output of consumer goods.

The hard economic fact of a dwindling output of consumer goods and services can be hidden for a time by bulging inventories. For a time stores have been able to continue to supply goods from ample stocks. But the pro-

pective covering of inventories is wearing thin in dozens of places. Bare spots in store shelves are becoming commonplace. The Christmas rush will further deplete stocks of available goods. The scarcity of nylon stockings and of rubber products has made the headlines; but they are only a symbol of what has already occurred, and only a foretaste of what is to come. Each scarcity that develops diverts purchasing power into other channels, creating additional scarcities and making the real cost of war more and more evident.

### *The Real Cost of the War*

Now we are getting away from conventional monetary symbols into a more realistic appraisal of the economic cost of the war. The budget figures I have given you can mean very little to most of us. But what I now have to say can mean a great deal, because it is definite and concrete. More of us will have to work more next year than this year. We shall have to work more hours than today, and more intensively. There will be a smaller supply of consumers' goods and services to reward us for our greater exertions. These are hard, physical facts. They cannot be obscured by any terminology. Neither taxes, nor any economic measures at our command, can change the picture. Civilian goods will not grow where war goods are planted. Harder work on the one hand, and a lower supply of goods on the other hand, constitute the price civilians must pay to win the war. They are the inescapable economic cost of the war.

This cost must be met *now* while we are fighting. It cannot be shifted to foreign countries. We will not, like the Axis, obtain resources by looting conquered territory. We cannot, because of the limitations of the industrial capacity of the neutrals and our Allies, obtain substantial resources by borrowing goods from abroad.

Likewise, the real cost of the war cannot be shifted to the future. Borrowing dollars at home in no sense postpones the real cost of the war to the future. By no financial manipulation can we reach our hands into the future, and bring back to the present guns and planes with which to fight this war. No financial legerdemain can transfer civilian goods and services from the future to the present. Future generations cannot arm our fighting forces. We of the present have no choice between paying for the war now and postponing the economic cost to the future. As sensible citizens we should turn, then, from what is impossible to what is only difficult. Although we cannot evade or postpone the economic cost of the war, we can, if we will, distribute that cost fairly. But we shall not find that an easy job.

*The Effects of Inflation*

The physical realities of hard work and short supplies have a monetary counterpart. Our increasingly intensive mobilization of resources means large and increasing incomes to workers and to investors. Our short supply of consumer goods means that there is relatively little for these incomes to buy. Thus, we have the paradox of large incomes and short supplies. Increased income has no place to go. It is burning holes in millions of pockets. This is the explosive factor in our economy.

As I have said, we have an inflationary gap of 15 billion dollars. Shall we permit this purchasing power to flow freely to the market for consumer goods and services? If we do, we may be sure of a wild competition for our short supply. Black markets will mushroom. Evasion and dealer favoritism will become commonplace. Empty shelves and illegitimate profits will become the order of the day. The distribution of the short supply of the necessities of life will be wasteful and inequitable. Competition to buy these necessities will be reduced to a disorderly, time-consuming scramble. The goods and services will go not to those who need them most, but to those who are least bound by limitations of time, money and scruples. The devil will take the hindmost. The ensuing hardships will be suffered particularly by the families in the low income groups.

This is one method of distributing limited supplies. It is the method of inflation. It is the method we used in the last war, and a method other countries have used to an even greater degree. We have made some use of the method during the past two years, though by default rather than design. Prices for consumer goods, as measured by the Bureau of Labor Statistics Cost of Living Index Number, have risen 19 percent during the past two years. This is only the handwriting on the wall.

It would be carrying coals to Newcastle to discuss at any length the meaning of that handwriting on the wall. Inflation is the most unsatisfactory method of distributing short supplies we could select. It is a method intelligent men would never explicitly choose. It imposes the heaviest burden on those who can least afford sacrifice and the lightest burden on those who can best afford sacrifice. Rising prices hit persons with fixed incomes much harder than persons with rising incomes. They affect persons with low incomes, who must ordinarily spend all of their income for goods and services, more heavily than persons with high incomes, who can maintain their standards of living despite rising prices.

Inflation also disorganizes the economic process. Business is conducted in terms of prices that are expected to remain fairly stable. Rapid price increase shifts the emphasis from production as a source of profit to specu-

lation and hoarding as a source of profit. The struggle of labor to keep wages in line with ever-rising prices adds to the confusion. If inflation takes precedence over production as the main concern of business and labor, the war effort will surely suffer.

Finally, inflation multiplies the monetary costs of the war and makes the post-war adjustment more difficult, if not impossible. If a given supply of war goods rises in price, we will be obliged either to raise taxes or to float more debt. The wake of inflation will be a disjointed price system, which will promote a policy to "watch and wait" until prices are again in line. Once they are in line—that is, when they have descended from inflationary heights—debts incurred at the high levels will be immeasurably harder to pay. The great farm debt was one of the most disastrous economic legacies of the inflation we suffered in the last war.

### *Direct Inflation Control*

We have taken two steps to control inflation. Congress made a direct attack on the problem in the first Price Control Act under which the Office of Price Administration established price ceilings. Congress made another frontal attack by its passage of the Second Price Control Act, following which the President created the Office of Economic Stabilization.

But the battle against inflation will not be won without the enactment of more fundamental measures than any we have yet adopted. It will not be won without heavy reliance upon fiscal weapons. Price ceilings and wage controls by themselves will check, but they will not halt, the upward course in prices. They will be successful only if they are reinforced by fiscal measures designed to restrict civilian spending, and to relieve the pressure on prices of unrestricted consumer purchasing. Such measures are an essential part of a comprehensive anti-inflation program. We must somehow accomplish an absorption by additional saving and taxes of 15 billion dollars of excess spending power.

To be effective, fiscal measures must be weighed in net, as distinguished from gross, terms. The goal for 1943 is to prevent 40 billion dollars of excess purchasing power from reaching the market for consumer goods and services. It will not do merely to shift saving now being made from a voluntary to an enforced status. Nor will compulsory lending out of accumulated saving contribute to the solution of the inflation problem. The net effect of such measures would be zero. Our task in 1943 will be to add to net individual savings and existing taxes.



*The Criteria of a Sound Tax Policy*

A sound tax policy must ride several horses at the same time. It must look to the expansion of war production; it must be adapted to post-war needs; its measures must be reasonably capable of administration. These things go almost without saying, and I wish to dwell today on less obvious criteria of a sound tax policy.

I have tried to describe to you in simple, concrete terms the inescapable economic cost of the war. The primary function of the tax system at a time like the present is to distribute that cost fairly and equitably. The test of a good tax measure is how it distributes that burden. In the next few weeks you will read of many tax proposals. I would like to urge upon you that you test each proposal made in the light of one basic group of facts. They are unpleasant facts. They are easily forgotten facts. But they must be remembered, or we shall lose our way to a sound tax policy.

Millions of our people are living today at a level that is barely adequate to keep them working efficiently in the factories and in the fields. Recent increases in income have been much advertised, and it has been seriously suggested that a special tax be put upon them. Yet the fact remains that these increases in income have represented to many families merely the possibility of changing a diet sufficient for a sedentary life of partial or full employment to a diet capable of sustaining a vigorous day at a swiftly moving machine. For other families, increases in income have represented nothing more than the maintenance of a previous meager living which can now be maintained only at a higher price. For still other families, increases in income have represented only a partial correction of many years lack of medical and dental care, inadequate clothing, and deficient shelter.

I do not want you to think that I am discussing problems of social welfare. I would make no apologies for discussing such problems, but in these days we need not place our emphasis upon social considerations. The problem of distributing the cost of a total war becomes in war a matter of military importance. The exemption of a minimum level of income from taxation, and the limitation of the war burden on those workers whose standard of living is barely adequate for productive efficiency, are the social cost of providing vigorous workers in our steel mills, in our coal pits, and on our farms.

So much for the broad considerations of policy that must enter into our war tax program. We must discard old notions that taxation is for revenue only. We must use taxation as an instrument of inflation control. We must recognize its function of distributing the economic burden of the war in a fair and equitable manner. In the light of these basic principles we

may turn to the immediate legislative situation, and to the proposals commonly, and sometimes strenuously, offered as solutions. We may even imagine the possible features of a Revenue Act of 1943. It would be a strange legislative year which failed to produce a revenue act. The 1942 Act was our twenty-first modern revenue act. I see no reason to abandon Karl Llewellyn's doctrine:<sup>2</sup> "For too much law, more law will be the cure."

### *The Income Tax*

We may perhaps best begin this phase of our discussion with the income tax. That is a tax to which we are accustomed. It has been a principal source of revenue for many years. To what extent may we rely upon that tax for the future under a war economy? To what extent shall we be obliged to resort to other methods of taxation?

I am not going to try to answer the question whether our income tax will be increased for the year 1943. That is a matter for Congress to determine. All that I can do is to indicate some facts that may not be fully realized. For this purpose we may first pass judgment on the Revenue Act of 1942. That Act may not have raised sufficient revenue; it may be an inadequate answer to the inflation threat; to use a metaphor of a predecessor Irvine lecturer, it may be no more than an inn that shelters for the night, and not the journey's end.<sup>3</sup> But much may be said in favor of the Act. It is certainly safe to say that it contains more relief provisions than any other revenue act in our history. More than half of its total of 208 pages, or 120 pages, are devoted to the relief of inequities. Many loopholes were closed which for years have offered opportunities for evasion.<sup>4</sup> The Act devotes 42 pages to the clarification and definition of existing provisions to enable more equitable and fair enforcement. This makes a total of 104 corrective sections out of a total of 173. In pages, this is nearly 78 percent of the Act, 162 pages out of 208. In this sense, if not in a fiscal sense, the bill will perform an outstanding service. We had reached the point in our rate structure where loopholes resulted in drastic loss of revenue, and where inequities and discrepancies threatened to be not only troublesome, but even disastrous to taxpayers. The tax structure had to be put in shape to carry an increased load. A part of this job was done in the Revenue Act of 1942, and we now have a basic tax structure which will be better able to stand the strain of increased rates.

---

<sup>2</sup>LLEWELLYN, *THE BRAMBLE BUSH* (1930) 122.

<sup>3</sup>CARDOZO, *THE GROWTH OF THE LAW* (1924) 20.

<sup>4</sup>Outstanding among the corrections of loopholes are the change in the capital gains provisions, the new treatment of pension trusts, and the termination of community property favoritism for estate and gift tax purposes.

Adhering to my purpose not to prophesy, let me make some comparisons. The Revenue Act of 1942 levies on citizens of this country the heaviest income tax they have ever been asked to pay. I have attached to my lecture notes a chart showing a graph of our income taxes commencing with the 1918 Act and going through to the 1942 Act.<sup>5</sup> Curves go down from 1918 to the delightful days of 1929, and then swing upward. The 1942 curve is well above the 1918 curve.

No one would want to deny the fact that sudden and sharp increases in income taxes will cause some hardship and much inconvenience, especially for the fixed income group. But that is not the same thing as saying that further use of the income tax is impracticable. I have also attached to my lecture notes a graphic comparison of the income taxes imposed by the United States, Canada, and Great Britain.<sup>6</sup> High as our income taxes now are, they do not reach the levels of these two members of the United Nations group. For example, in the United States, a married person without dependents who receives a \$5,000 net income will pay in the form of income taxes, including the Victory tax, less than one-fourth of his income. In Canada he would pay more than one-fourth of his income; in Great Britain almost one-third. To cite another example: A single person without dependents who receives a \$2,500 income will pay 18 percent in the United States; 25 percent in Canada; and 29 percent in Great Britain. Certainly, we can have higher income taxes if we can take what the British and the Canadians are taking.

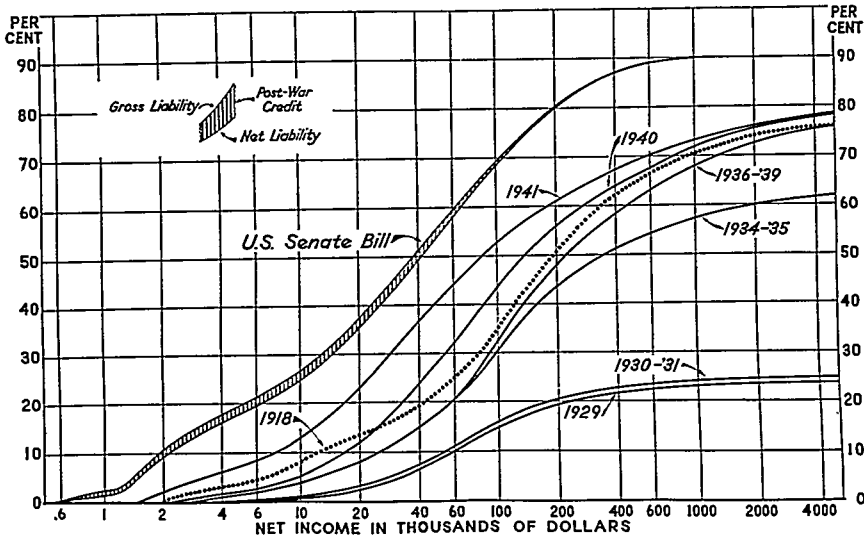
We must recognize, however, that the income tax can be improved to meet the needs of the present. Our concept of income has its limitations. Certain types of income, such as home-produced commodities, are not taxed. Some items which are not income may be subjected to tax. The expense of getting to and from work, and of moving to take a new job, are illustrations. Some defects of the income tax, such as the exemption of the income from state and local securities, could be remedied by legislation, though the Treasury Department has encountered much resistance to any such legislation. Other defects, such as the failure of the tax to reach the rental value of an owner-occupied home, are exceedingly difficult to remedy. Differences in the costs of living, problems of capital gains and losses, and the specifications of deductions, create still more difficulties. Other limitations stem from faulty definitions of the taxpayer unit. There are here further defects than can be reached by the Treasury joint return proposal. Every increase in rates adds to the gravity of these imperfections of the income tax.

---

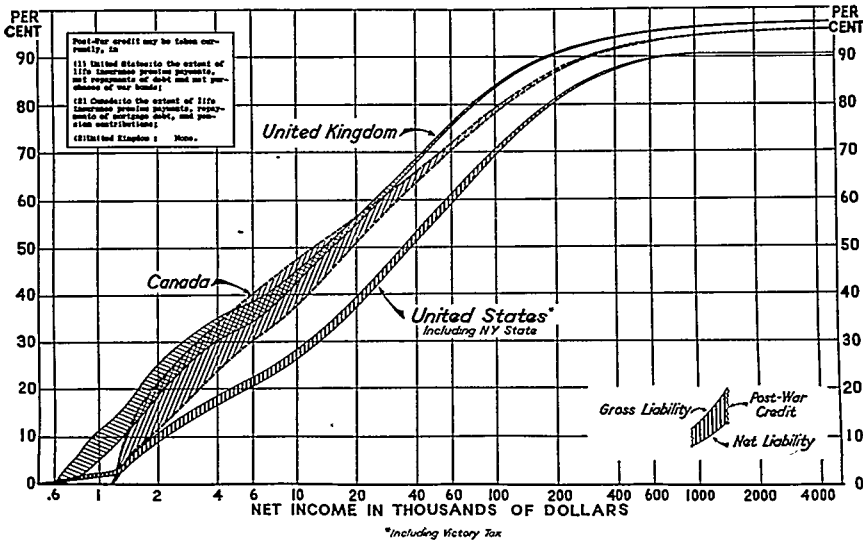
<sup>5</sup>See p. 151.

<sup>6</sup>See p. 151.

INDIVIDUAL INCOME TAX  
Effective Rates for Married Person without Dependents  
1918 and Selected Taxable Years



INDIVIDUAL INCOME TAX  
UNITED STATES, UNITED KINGDOM AND CANADA  
Effective Rates for Married Person without Dependents



Income taxation adequate to siphon off sufficient purchasing power to remove the danger of inflation will require the extension of high tax rates to *lower* incomes, as well as sharp increases in rates on *higher* incomes. Without safeguards, this may have an adverse effect on the incentives to make the exertion required for an all-out war effort. Labor may be reluctant to work overtime, and married women may be hesitant to accept war jobs if too large a part of the additional income is taken by the income tax.

When tax rates were at peacetime levels many individuals assumed long-term obligations which they are unable to readjust on reasonable terms. They have obligated themselves to devote large parts of their income to the repayment of debt, to the payment of life insurance premiums, to mortgage payments, and to other savings programs. Although the war will inevitably impose personal hardships, avoidable burdens need not be imposed. Recent increases in tax rates have been so sudden that many taxpayers have not been able to rearrange their financial affairs. In making further increases of sufficient magnitude to meet present and prospective needs we should make certain that they are not unnecessarily harsh in their impact on large numbers of taxpayers.

We can place much greater reliance on the income tax than we have thus far. In doing so, however, we will do well to make those refinements in the structure of the tax which were desirable even in the past, but have become indispensable in the present.

### *The Individual Excess Profits Tax*

One modification suggested in the form of the income tax is a special tax on increases in individual income. Such a supplement to the income tax has a special appeal in time of war, because many individuals do enjoy increases of income as a direct result of the war, and also because individual proprietorships and partnerships are exempt from the excess profits tax, although their profits are sometimes substantial.

But when we look more deeply into the matter, we quickly find that a tax on increases in individual income would have serious shortcomings. A large part of the recent increase in national income represents higher wages earned by those in the lower income groups. In many cases these higher wages result from steadier employment, more hours of work, extra pay for overtime, and bonuses for extra output. The combination of a special tax on increases in individual income and increases in the regular income tax, at a time when many workers are called upon to pay income taxes for the first time, might seriously deter many individuals from asserting the maximum war effort.

Furthermore, a special tax on the excess of current income over income

in a specified base period would discriminate against certain groups of taxpayers. The most conspicuous case, perhaps, is the one whose income was abnormally low in the base period, or who was unemployed and was entirely without income in the base period. I am not anxious to be the person who has to explain why one of two individuals both receiving \$2,000 income has to pay more tax than the other. I would probably get the reply that the individual who had no income in the base period had less current taxpaying ability than the person who earned \$2,000 continuously over the past few years. Presumably, the individual with a steady income, who has been able to maintain his person and property in good repair, is at least as well able to bear the war burden as the worker who is employed for the first time in years.

A tax on increases in the incomes of individuals would be especially burdensome in the case of a member of the family who becomes a wage earner to compensate for the loss of earnings of another member of the family who has become unemployable, or who has been called for military service. Where a son or husband has entered the armed services, the family income is likely to be reduced, even though the wife or another member of the family receives a larger income now than in the base period. In all probability, under a special tax on increases in income, inequity to this kind of case could not be avoided; and from present indications there will be millions of such cases.

A super-tax of this type would impinge also on normal increases in income not in any way connected with war profits. The modest increase in the salary of a postman, fireman, or a college professor, in accordance with an established promotion schedule is an example. The tax would bear with particular weight on those who are at present establishing themselves professionally. An engineer who, after years of study and training, finally secures a post illustrates this type of case. The craftsman who, as a result of the war, is for the first time afforded an opportunity at work of greater responsibility and skill within his competence, is another illustration.

The administrative problems involved in ascertaining what individuals were liable to this tax, and in determining the amount of their tax liability, would be extremely complex. For the great body of taxpayers, no means would be available for checking the income of the base period. Income tax records would be available for only a relatively small number, because until recently high exemptions excluded most of the public from the requirement of reporting. In addition, many persons having no intention of evading taxes simply do not have accurate information about their income in past years.

A tax of this type would probably have to contain extensive relief pro-

visions to safeguard individuals with abnormalities in base period income, or with extraordinary income in the current year, particularly where income is derived from small proprietorships and partnerships. We have had enough experience with analogous problems in the corporate field to know well the administrative difficulties.

These considerations, together with the fact that any practicable scheme would yield little revenue and would contribute even less to the control of inflation, make this modification of the income tax highly questionable.

### *The Sales Tax*

I probably do not need to tell you the Treasury attitude toward the sales tax. We have been roundly criticized for our opposition to that tax. I make no apology for opposing it. I would like to give you today some of the reasons why I have done so.

My first objection to the sales tax goes to the point of equity. I can imagine no more unfair way of distributing the economic cost of the war. The Secretary of the Treasury phrased this objection in crisp words in his statement to the Ways and Means Committee on March 3, 1942: "The general sales tax falls on scarce and plentiful commodities alike. It strikes at necessities and luxuries alike. As compared with the taxes proposed in this program, it bears disproportionately on the low income groups whose incomes are almost wholly spent on consumer goods. It is, therefore, regressive and encroaches harmfully upon the standard of living."

To the Secretary's statement I would like to add some details. If we imposed a general retail sales tax on consumer purchases large enough to equal 10 percent of the income of a person with consumer income under \$500, the tax would amount to only 6 percent of an income between \$2,000 and \$2,500, and 3 percent of an income above \$10,000. It would have an effect similar to imposing an income tax without exemption at the rate of 10 percent on an income of \$500, at 6 percent on an income of \$2,500, and at 3 percent on an income above \$10,000. The idea is fantastic when we consider imposing such rates under the income tax. But when we consider the imposition of a sales tax, we should keep in mind that that is the way the tax would distribute the burden of the war.

There are at least three places in the economic chain where a sales tax could be imposed. The tax could be imposed on manufacturers, on wholesalers, or on all retail sales. The task of administration varies enormously according to which one of these taxes is adopted. The tax on manufacturers would probably be the easiest to administer and enforce. Such a tax would be directly paid by 157,000 manufacturing taxpayers. A tax on sales

by wholesalers would not be greatly different from the administrative point of view. It would be directly paid by some 306,000 taxpayers. Either of these taxes could be administered by a relatively small force.

But here is the dilemma. Either of these taxes would play havoc with our whole system of price control. It would do so because a tax at these early stages in the production-distribution process would be treated as an ordinary cost of doing business. This would lead to the necessity of determining how the tax affected the cost of each particular product, of examining every situation to see whether the seller could absorb the price increase, and, if not, of granting increases above the ceiling prices. Each such increase would necessitate still further increases at subsequent stages in the productive and distributive process. The difficulty of preventing the maintenance of percentage margins might lead to increases greater than the tax imposed. The Office of Price Administration has every right to "shudder," to use Mr. Henderson's word, at the thought of how that office would be swamped if such a tax were passed.

The retail sales tax to some extent gets by this Scylla only to run into Charybdis. While it would affect price ceilings, it would not demolish them. But its administration would be very difficult at a time like the present. There are over two and one-half million business units selling at retail. A tax on retail sales would require frequent tax returns from every one of these taxpayers. It would require a huge administrative force; a large, well-trained field staff to audit the taxpayers' books periodically is the backbone of an efficiently administered retail sales tax. The personnel problem becomes almost insuperable at a time when there is such great demand by war industries and many branches of the Government for personnel. In addition we have the problem of accounting and business machines, desks, chairs, filing cases, stationery, forms, office space, and transportation for a field staff.

I would like to plead also for some realism about the revenue that could be expected of a sales tax. The sales tax advocates are romantics on this subject. I will not bore you with detailed figures, but I would like to call your attention to the fact that the wartime base for a sales tax on tangible goods would probably be less than 50 billion dollars; the rest of the 70 billion dollars total of consumers' goods and services represents services which cannot readily be subjected to a sales tax. The minute we begin to grant exemptions, this 50 billion dollar base dissipates. It would be reduced to 30 billion dollars if we exempted food. Put the matter around the other way: In order to raise only 5 billion dollars, a sales tax of 11 percent would



be required if food were included in the tax base, and 17 percent if we mitigated the regressive character of the tax by exempting food.

Much of the support given the sales tax stems from the erroneous belief that foreign countries have found the sales tax an indispensable weapon of war taxation. Actually, most European countries, like our own states, introduced the sales tax not in time of war, but at a time when other revenue measures became unproductive. They adopted it in depressions when the income tax base disappeared and in periods of hyper-inflation when income taxes assessed one day became meaningless the next.

In Great Britain and Canada the relative importance of sales taxes and customs has declined as the war has progressed.

Canada makes important use of consumption taxes. But the ratio for the Dominion, which was 51.8 percent in the fiscal year 1942, is estimated to decrease to 34.6 percent in the fiscal year 1943. It is significant that Canada adopted the general sales tax long before the war, and that it has consistently refused to increase the tax rate for purposes of war finance.

The British Purchase Tax applies high rates to a very wide range of commodities. But it leaves numerous articles untaxed. In fact, it applies to substantially less than 20 percent of consumer expenditures. Three principal groups of commodities are not taxed: (1) absolute necessities, including food, coal, and utility services; (2) goods already taxed, such as gasoline, tobacco, and drinks; and (3) most industrial machinery and equipment and materials. The expected yield in 1942-43 is only 80 million pounds, less than 3 percent of national and local revenue. This represents a decline from about 4 percent in 1941-42.

The United States already makes considerable use of taxes on consumption. In 1942 the ratio of sales taxes and customs to total taxes imposed by all levels of government was 25.2 percent in the United States. The corresponding ratio for the United Kingdom was 30.2 percent—and that includes the Purchase Tax.

The sales tax is too crude an instrument to do an effective job in controlling inflation. It is not sensitive to differences in spending capacity. Every person pays the same tax rate whether he contributes one dollar or a million dollars to the stream of inflationary spending power. Thus, the tax fails to discriminate between persons who can reduce their purchases substantially and persons who cannot do so. In consequence, it is impossible to impose a sales tax at sufficiently high rates to curtail the consumption of persons whose living standards are liberal, without at the same time levying an intolerable burden on tens of millions of our citizens. If it is imposed

at low rates, the sales tax will exercise little or no restraining influence on the persons who are in the best position to reduce their standards of living.

It would be fatuous in planning a tax program for today to leave out tomorrow. The tax system of the war period will be the tax system of the post-war period except to the extent that provisions are deleted by later Congresses. There is such a thing as legislative inertia, and there are such things as special pressure groups that enter into the equation of future tax policy. Of course, any tax now needed in the light of war conditions should go into our structure. But where the scales are nicely balanced, it is proper to question a proposal from the viewpoint of whether the suggested tax would be a proper part of a permanent tax system. The sales tax may be questioned on this point. If we think it would not be a sound permanent measure, we had better realistically remember that if we adopt it now it will be in the system when the war ends. What will be the first deletion then? Will there be a reduction of progressive income tax schedules or an elimination of the regressive sales tax? I cannot give the answer to this question, but I am able to foresee pressure in favor of the diminution of the taxes that bear most heavily on those who are most able to bear post-war taxes.

### *Compulsory Saving and Compulsory Lending*

Two measures, which assign tomorrow a prominent place in the framing of today's fiscal program, are compulsory saving and compulsory lending. These measures are like taxes in that they compel the taxpayer to do specified things with his money. But, unlike taxes, they give him a financial claim against the future. For his payment he receives a promissory note rather than a mere tax receipt.

In discussing compulsory saving and compulsory lending, I should first like to clear the murky atmosphere which envelops these proposals. Current discussion tends to use interchangeably the terms "compulsory saving," "compulsory lending," "minimum saving," and "forced loans." Actually, saving and lending may be two quite different things, and putting them on a compulsory basis by no means resolves the differences. Compulsory lending imposes the legal obligation to lend to the Government an amount equalling a specified fraction of income, expenditure, or other base. The amount loaned may come from any source as long as it equals the specified fraction of the chosen base. Compulsory saving, on the other hand, imposes a legal obligation to save a specified fraction of income.

Notice, if you please, that I did not say "an amount *equalling* a specified fraction." Compulsory saving specifies a minimum amount which must be

saved out of income itself, and the savings requirement cannot be met by converting other assets or by borrowing money. To clarify the difference between the two, let me point out, finally, that an individual can lend to the Government without saving, by drawing on accumulated assets or by borrowing, and that he can save without lending to the Government, by investing in assets other than Government bonds. Compulsory lending is now in effect in a mild degree under the new Victory Tax.

In sharply differentiating compulsory lending and compulsory saving, I do not mean to ignore the things they have in common. Both of them can be made progressive in their incidence through the provision of exemptions and the use of graduated rates. Both of them can recognize fixed commitments and extraordinary expenses by allowing offsets for such things as personal taxes, rent, medical expenses, debt repayment, and the like. Both of them can contribute to the control of inflation by immobilizing consumer spending power. Finally, both of them enjoy certain advantages over taxation in this process.

Compulsory lending and compulsory saving both preserve the incentive to work by postponing, rather than taxing away, the rewards of labor. The promise of future rewards inherent in either of the measures also justifies a greater restriction of consumption among the lower income groups than would be justified under outright taxation. And, of course, larger total levies on all income groups become more acceptable when we are promising to return what we take at the moment. Finally, compulsory lending and saving schemes create a reserve of individual purchasing power for the post-war period.

In addition to the advantages over taxation which it enjoys in common with compulsory lending, compulsory saving is more effective than the lending plan in its immediate impact on consumer spending. The only way to meet the savings requirement is to spend less; lending, however, need not replace spending, since it may come out of accumulated savings, or out of current income that would have been saved anyway. Compulsory saving fixes a net savings requirement for each individual according to his income and family status. By pitching the schedule of requirements to the difference between individual incomes and the value of available consumer supplies, compulsory saving offers a comprehensive solution to the problem of inflation. The form of the saving is relatively immaterial, the vital point being the removal of the excess income from the inflationary channels of consumer spending.

The attractiveness in principle of compulsory saving leads us to the final test of any tax measure—its administrative feasibility. To enforce the savings requirement would demand a knowledge not only of each person's

income and family status, but also of changes in his capital position. His asset and liability status at the beginning of the year would have to be compared with that at the end of the year. This is not an insuperable problem. More formidable, however, is the difficulty of enforcing saving out of income concurrently with the receipt of that income. We are basing obligations upon a fact before it becomes a fact, because the savings requirement cannot be known precisely until income is known, and income cannot be known precisely until the period is ended.

One method of enforcing the savings requirement would be to issue to each consumer a license to spend only a specified amount on consumer goods and services; in this event, compulsory saving would become expenditure rationing.<sup>7</sup>

### *Social Security*

A governmental program now in operation, which has fiscal implications somewhat similar to those of compulsory lending, is the social insurance system. Social insurance is compulsory, and it involves payments into a fund from which benefits are later paid on the insurance principle to the insured contributors. A social insurance program should be considered and judged primarily by the effectiveness with which it furnishes the protection against risks that the bulk of the population faces in a modern industrial nation. However, it should be observed that expansion of social insurance has fiscal effects similar to those of compulsory lending. During the early years of a social insurance program, and especially during the war period when incomes are high, the contributions tend greatly to outrun the benefits, while in years when the economy is running at low gear and social insurance benefit obligations are high, the payments will exceed the contributions. For the wartime period a substantial expansion of the social insurance system involving increased contributions in the form of a payroll tax, or some other form of tax, would have distinctly anti-inflationary effects.

### *The Spendings Tax*

The spendings tax is another method of increasing saving. This tax has never been tried in this country. It is now urged as a supplement to the more conventional income tax because at high rate levels that tax is not sufficiently selective in its impact. The spendings tax was proposed by Ogden

---

<sup>7</sup>Briefly, expenditure rationing is really the reciprocal of compulsory saving. Instead of telling people what minimum amount they must save, expenditure rationing tells them what maximum amount they may spend on the broad assortment of goods which is the subject of inflationary pressure. For a more complete discussion of the measure, see my address before the American Academy of Political and Social Science, November 30, 1942.

Mills in 1921,<sup>8</sup> and has been advocated for many years by Professor Irving Fisher of Yale.<sup>9</sup> These gentlemen have advocated the spendings tax, however, as a permanent part of our revenue system. I do not. I think of the tax as a temporary war measure designed to have a very substantial anti-inflationary effect.

As its name indicates, the spendings tax is imposed on expenditures for consumers' goods and services. It is not imposed upon income received, nor upon income devoted to the purchase of capital assets. The base of the tax consists of the difference between income received and income saved by being applied to debt payments, life insurance premiums, the purchase of war bonds, and the acquisition of other capital assets. Further deductions, such as rent, medical expenses, and educational expenses, can be allowed if desired. Of course, there is a deduction for the amount of the regular income tax. You will note that the taxpayer is not obliged to keep account of his individual expenditures for different items of consumers' goods and services. The amount of individual spendings would be arrived at indirectly by deducting from the total amount of available funds sums spent for purposes other than personal consumption.

The spendings tax has two important advantages over the sales tax. It is possible under the spendings tax to provide for whatever exemptions and deductions are deemed necessary to protect those whose low standard of living threatens to impair their productive efficiency. It is also adaptable to the use of progressive rates. Thus it differentiates among taxpayers on the basis of ability to pay and distinguishes between "luxury" and "non-luxury" spending. When the tax applies to specific commodities, as under the sales tax, it is necessary to classify them for purposes of establishing their rates according to some criterion of luxury. If commodities are enumerated, many knotty problems of definition arise, which add greatly to the administrative problem. If price is made the criterion, many goods are taxed at the higher luxury rates merely because the goods are made to last longer. Furthermore, if general prices are rising, some commodities become luxuries merely because their prices have risen.

The spendings tax does not require difficult decisions as to what constitutes a luxury; the basis for graduating the rates is the total spending of the individual. If his spendings are high, it is presumed that they are devoted in part to luxuries, and they are taxed accordingly. Furthermore, the spendings tax can make allowance for the size of family, whereas the burden of the sales tax increases with the number of dependents. A further

---

<sup>8</sup>H. R. 7867, 67th Cong., 1st Sess. (1921).

<sup>9</sup>FISHER AND FISHER, *CONSTRUCTIVE INCOME TAXATION* (1942) pp. X, 249.

advantage of the spendings tax over the sales tax is that it does not tend to enter into costs of production, and hence it does not contribute to price inflation.

I cannot take time to tell you in detail the many further advantages of the spendings tax. It will not strike at those who spend only enough to provide a minimum standard of living. It will strike only moderately at those who live in moderate comfort. It will strike hard at those who maintain a high level of personal expenditure, and who thereby make unjustifiable demands upon the reduced national supply of consumers' goods and services. The tax is a powerful instrument for facilitating a fair distribution of the limited supply of goods and services available. In this respect it would be an important supplement to rationing. By placing a tax penalty on the excessive expenditures of the wealthy it would prevent the wealthy from monopolizing the supply of goods, thus leaving a larger share for those with more moderate means. By mopping up a part of the restless funds seeking outlets in consumer spending, the spendings tax would minimize the danger of major breaks in our price ceilings through the competitive bidding-up of prices.

I might mention one further important consideration. The purpose of the spendings tax is to discourage spending and to stimulate saving. To the extent that revenue is produced by the tax, the Treasury benefits. To the extent that individuals avoid the tax by not spending, the pressure of inflation is released. The resultant personal savings become available for borrowing by the Government either directly or from the individual or indirectly from financial institutions. Incidentally, the tax will therefore provide an increased measure of individual security and a backlog of purchasing power that will be available after the war when production can again be directed toward civilian needs.

One final point. The spendings tax leaves the taxpayer substantial latitude. He may decide upon the amount of his spendings. He can spend if he is willing to pay the price in higher taxes, but he is strongly induced to postpone this spending. The decision he makes will determine the size of his tax. Thus, he is to a considerable extent his own tax assessor.

### *Conclusion*

I hope that none of you came here today with the expectation of getting a neatly packaged solution of our fiscal problem. If there is any such person in the room, I am afraid he must suffer the fate of most optimists. There is no economic litmus to give ready answers to so endless, so complex, and so novel a problem as taxation in total war. There is no solution to such a

problem as one finds an answer to a problem in algebra or geometry; there seldom is to any of the real problems of life. The science of taxation is a poor, inexact science; it has many pressures and shades of contradiction. Honest opinions differ widely, and we must all find our ways as best we can through tangles of imperfectly understood situations, past conflicts of values that cannot be wholly resolved, to answers which have to do.<sup>10</sup> Powerful economic forces produce problems which must be handled with whatever fallible and tentative wisdom legislators can utilize.<sup>11</sup> I am simply giving you a few intensely personal opinions on debated points. I have not meant to be dogmatic; one is entitled to be very suspicious of tax theorists who are too sure of their answers. Dogmatists so often try to disguise difficulties by sweeping all the chessmen off the table. For my definition of a competent tax policy man, you can start with Holmes's definition of a liberal: he is "a person who does not imagine himself to be God."<sup>12</sup>

The responsibility for tax legislation is in Congress, not the Treasury. All the Treasury can do is to suggest and advise; it proposes and Congress disposes. I must, therefore, refrain from the thankless task of prophecy. I do not know what taxes will be enacted in 1943; I do not know what the scope and magnitude of the 1943 program will be; I do not know what proportionate contribution each type of solution I have discussed will make to the aggregate 1943 program. To attempt to answer these questions would be to enter into a field of prophecy for which I do not feel qualified. No program of fiscal legislation for 1943 has yet been formulated, so far as I know. It is still in what the President calls "the discussion stage." All I can say today is that I sincerely hope that the principles I have stated here will not be forgotten when the legislative mills grind out our twenty-second modern revenue measure.

As I look back on the 1942 Act and forward to the 1943 Act, I must confess a nostalgic yearning for the old simplicities and delusive exactnesses<sup>13</sup> many Americans once thought they enjoyed. The past of taxation has an enchantment in direct proportion to its distance in time. In long retrospect, it has a charming quality of 19th century moderation. We had nearly reached the end of the 19th century when prominent New York lawyers, strenuously arguing before the United States Supreme Court against

---

<sup>10</sup>Cf. LLEWELLYN, *THE BRAMBLE BUSH* (1930) 35.

<sup>11</sup>See Frankfurter, *Mr. Justice Cardozo and Public Law* (1939) 52 HARV. L. REV. 440, 452; (1939) YALE L. J. 458, 470; (1939) 39 COL. L. REV. 88, 100.

<sup>12</sup>Beard, *Why Did We Go to War* (1937) 90 THE NEW REPUBLIC 127, 129.

<sup>13</sup>*Martin v. District of Columbia*, 205 U. S. 135, 139, 27 Sup. Ct. 440 (1907); HOLMES, *COLLECTED LEGAL PAPERS* (1920) 306; *Safe Deposit and Trust Company of Baltimore*, 35 B. T. A. 259 (1937), *aff'd*, 95 F. (2d) 806 (C. C. A. 4th 1938).

the constitutionality of a two percent income tax, could hardly contain emotions which moved them to call the act "communistic in its purposes and tendencies" and confiscatory.<sup>14</sup> They were able, by the narrow margin more characteristic of later days, to inter income taxation until thirteen years of the new century had passed. Even then we enacted an income tax of 19 pages at the almost unbelievably low rates of 1 to 7 percent. That was only thirty years before the enactment of our twenty-first revenue act, the Revenue Act of 1942, which, without the Victory tax, reached rates of 19 to 88 percent and attained a length of 208 pages.

Those were the happy days. Whirl had not deposed Zeus, to become King in his own right.<sup>15</sup> Since then an era has passed. Change—with its long arm, its disturbing touch, its decree of events not yet manifest—has come to all the "folkways" of taxation. Tax issues are now stated in novel ways; concepts dominant have exchanged places with concepts recessive; new relationships and shifts of base are born of every economic event. Everything we do is brimful of consequences. We are writing a significant chapter in tax history.<sup>16</sup>

It is pleasant to remember the old days. My mind can share the longing of every human mind for certainty and repose.<sup>17</sup> But I know of no more wasteful process than wishful thinking that such a golden age will ever return for any of us here today. Such thinking is what should be expected of George Chappell's birds, which flew backward rather than forward because they liked to see where they had been rather than where they were going. I can hardly be suggesting too much if I suggest that we courageously face the future, no matter how different it may be from the past.

Who can describe that future? I shall not be bold enough to try. It is a future without precedent. It has no clear securities, only "potent imponderables."<sup>18</sup> It is a future in which often we shall have to act in the dark, sometimes mistakenly, upon the basis of available information, however unreliable it may be. There will be no fields of black and white. It is a future in which we shall have to wager our salvation constantly upon an

---

<sup>14</sup>Pollock v. Farmers' Loan & Trust Co., 157 U. S. 429, 532, 534, 15 Sup. Ct. 673 (1895).

<sup>15</sup>ARISTOPHANES, THE CLOUDS, Line 1471.

<sup>16</sup>Cf. Hamilton and Braden, *The Special Competence of the Supreme Court* (1941) 50 YALE L. J. 1319, 1320.

<sup>17</sup>HOLMES, COLLECTED LEGAL PAPERS (1920) 181.

<sup>18</sup>International Association of Machinists v. National Labor Relations Board, 311 U. S. 72, 79, 61 Sup. Ct. 83 (1940). See Stone, C. J., dissenting in Great Northern Ry. Co. v. Weeks, 297 U. S. 135, 153, 56 Sup. Ct. 426 (1936); Palmer v. Connecticut Ry. & Lighting Co., 311 U. S. 544, 61 Sup. Ct. 379 (1941).



inarticulate and unconscious judgment.<sup>19</sup> The old certainties are gone. The only remaining certainty is that "there is no gospel that will save us from the pain of choosing at every step."<sup>20</sup>

---

<sup>19</sup>HOLMES, COLLECTED LEGAL PAPERS (1920) pp. 181, 239; CARDOZO, THE NATURE OF THE JUDICIAL PROCESS (1921) 12; FRANK, LAW AND THE MODERN MIND (1930) 148 *et seq.*

<sup>20</sup>CARDOZO, THE GROWTH OF THE LAW (1924) 65.